

Case Note

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**THE PUNITIVE DAMAGES REMEDY:  
LESSONS FOR DRAFTERS OF  
ARBITRATION AGREEMENTS**

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Reprinted from the *Dispute Resolution Journal*, vol. 60, no. 4 (November 2005–January 2006),  
a publication of the American Arbitration Association, 335 Madison Avenue,  
New York, NY 10017-4605, 212.716.5800, [www.adr.org](http://www.adr.org).

**The 8th Circuit recently reinforced the principle that arbitrators can award punitive damages absent a clear and unequivocal waiver by the parties. The court affirmed an award of punitive damages even though the contract stated that any arbitration award “shall in no event include ... punitive, exemplary or treble damages as to which borrower and lender expressly waive any right ... to the fullest extent permitted by law.” The court found that because the governing law did not permit waivers of punitive damages, and because the waiver was only “to the fullest extent permitted by law,” the language was unambiguous in permitting punitive damages.**

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**A** principle well established in arbitration law is that, unless the parties expressly and unambiguously preclude an award of punitive damages in their arbitration clause, the arbitration tribunal will be able to award punitive damages. Federal courts applying this principle have recently expanded this doctrine to grant arbitration panels more freedom to award punitive damages than trial courts have. Recently, the U.S. Court of Appeals for the 8th Circuit re-affirmed this principle and ruled that it was not excessive for an arbitrator to award punitive damages that were 3,000 times the compensatory damages, even though these punitive damages would be excessive as a matter of law had they been awarded by a court.<sup>1</sup> This decision on punitive damages reinforces for attorneys the importance of employing direct and unambiguous language in crafting arbitration clauses. It also demonstrates the power of arbitrators to award damages that would not be permitted in traditional litigation.

### **Punitive Damages and Arbitration: Background**

In 1995 the U.S. Supreme Court confirmed the power of arbitrators to award punitive damages in *Mastrobuono v. Shearson Lehman Hutton, Inc.*<sup>2</sup> In that case, the Court upheld an arbitral award of punitive damages notwithstanding that the contract at issue was governed by New York law, which had legal precedent precluding punitive damage awards in arbitration. The arbitration clause incorporated the rules of the National Association of Securities Dealers, which specifically permitted punitive damages awards. The Supreme Court resolved the conflict between

### **The *Stark* Case: Was the Right to Punitive Damages Waived?**

The issue of the propriety of a punitive damages award surfaced again in *Stark v. Sandberg, Phoenix & von Gontard, P.C.*, in which the 8th Circuit considered an appeal of a district court order vacating a \$6 million punitive award in arbitration and the companion award of \$2,000 in compensatory damages.<sup>7</sup> The district court vacated the awards on two grounds: First, the contract precluded an award of punitive damages; second, the punitive award was excessive. The 8th Circuit disagreed, reversing the district court's judgment and reinstating the award.

***This decision on punitive damages reinforces for attorneys the importance of employing direct and unambiguous language in arbitration clauses.***

New York law and the party-selected arbitration rules by concluding that the choice-of-law provision applied only to substantive legal issues, and that the arbitration clause applied to non-substantive issues, including the award of damages. On this basis, the Court held that the application of New York law did not preclude an arbitral award of punitive damages.

Following *Mastrobuono*, lower courts have strictly construed contracts to determine whether there is a clear, express waiver of punitive damages awards in arbitration. For example, in *R. Allen Fox Ltd. v. Stratton Oakmont*, the court held that that contract language stating that New York law would control the “rights and liabilities of the parties” was not broad enough to preclude an award of punitive damages in an arbitration and that only specific language could do so.<sup>3</sup> A California court considering the same contractual language arrived at the same conclusion, reasoning that an arbitration panel's award of punitive damages was not in “manifest disregard of the law” because there was no language specifically precluding punitive damages in the contract at issue.<sup>4</sup> The 11th Circuit upheld an award of punitive damages over an argument that the award violated due process rights.<sup>5</sup> The court held that *Mastrobuono*, which dealt with a “virtually identical” arbitration clause, confirmed that arbitrators have the right to award punitive damages and that there can be no due process violation when the dispute is between private parties.<sup>6</sup>

The case dealt with a lending agreement between the Starks and EMC Mortgage Corp. The arbitration clause in the parties' agreement stated that an arbitration award “shall in no event include consequential, punitive, exemplary or treble damages as to which borrower and lender expressly waive any right to claim to the fullest extent permitted by law.”<sup>8</sup>

The parties ended up in arbitration as a result of a foreclosure dispute. The arbitrator found that the contract was ambiguous as to the availability of punitive damages because it stated that it was to be governed by both the Federal Arbitration Act (FAA), which allowed parties to waive of punitive damages, and Missouri law, which did not. In light of the ambiguity, the arbitrator construed the contract against EMC, the party that drafted it. Accordingly, the arbitrator found that an award of punitive damages was not precluded by the parties' agreement and imposed punitive damages of \$6 million against EMC. EMC moved to vacate the award and the district court granted the requested relief.

The 8th Circuit agreed with the arbitrator's conclusion that punitive damages were not precluded, but it did not apply the arbitrator's reasoning. It ruled that the contract language unambiguously permitted a punitive damages award. The court interpreted the waiver language in the agreement as a “limited waiver” of punitive damages because it applied “only to the extent permitted by ... law”—i.e., if the governing law permitted such a waiver.<sup>9</sup> Because Missouri law, the

law governing the agreement, made waivers of punitive damages unenforceable under the facts of this case, the 8th Circuit held that the contract unambiguously permitted an award of such damages. The court accepted that, under the FAA, parties can incorporate terms into their arbitration clause that are contrary to state law, but in its view, the parties had not done so in this contract. Accordingly, the court held that the award of punitive damages was proper.

The court also ruled “alternatively” that the arbitrator’s finding of ambiguity in the contract was appropriate. It stated: “Words purporting to waive claims which cannot be waived ‘demonstrate the ambiguity of the contractual language.’”<sup>10</sup> The court then concurred with the arbitrator’s decision resolving the ambiguity against EMC.

### The Amount of Punitive Damages Awarded

EMC also challenged the amount of the punitive award, claiming that \$6 million, which was 3,000 times the actual damages awarded, was excessive and, therefore, in manifest disregard of the law. The mortgage company contended that the award was inappropriate under *State Farm Mutual Automobile Insurance Co. v. Campbell*<sup>11</sup> and other recent Supreme Court decisions. In *State Farm*, the High Court reversed a punitive damage award that was 145 times actual damages, considering it to be excessive under the Due Process Clause. The Court said of its prior precedent on punitive damages that, although there is no bright-line rule, “[t]hey demonstrate what should be obvious: Single-digit multipliers are more likely to comport with due process, while still achieving the State’s goals of deterrence and retribution, than awards with ratios in range of 500 to 1 [ ] or, in this case, of 145 to 1.”<sup>12</sup> Because this limitation would obviously apply to a court considering a dispute, EMC contended that a similar limitation should apply to an arbitral award.

The 8th Circuit found EMC’s arguments

unpersuasive. The federal appeals court explained that the “manifest disregard” standard requires the award to stand unless “the arbitrators clearly identif[ied] the applicable, governing law and then proceed[ed] to ignore it.”<sup>13</sup> EMC had not, however, demonstrated that it had informed the arbitrator about limitations on punitive damages, notwithstanding that the arbitral award against EMC predated the *State Farm* decision. Thus, there was no evidence the arbitrators ignored the governing law. Accordingly, in the court’s opinion, the arbitrator in *Stark* had not manifestly disregarded the law. The court recognized that the result may appear “draconian,” but EMC “got exactly what it bargained for” in choosing “to resolve this dispute quickly and efficiently through arbitration.”<sup>14</sup>

### Drafting Provisions that Preclude Punitive Damages

An important lesson to be learned from the cases discussed above is that drafters of contract language must not fail to clearly express the intent to preclude punitive damages in an arbitral award. These cases also teach that courts appear to narrowly construe attempts to limit punitive damages in arbitration, making the drafter’s task all the more important.

The provision excluding punitive damages awards in arbitration proceedings should be clear and unambiguous. It should state without qualification that such awards are not available to either party. A clause that purports to bar punitive damages without using the phrase “punitive damages” will likely fail in its goal. A clause that uses limiting language (such as “to the fullest extent of the law”) in conjunction with denying the arbitrator the power to award punitive damages, could work against that intent. Because of the financial significance that a drafting error could have, drafters must consider carefully the choice of law governing the contract and the choice of arbitration rules, as these can play a part in the availability of punitive damages. ■

### ENDNOTES

<sup>1</sup> *Stark v. Sandberg, Phoenix & Von Gontard, P.C.*, 381 F.3d 793, 803 (8th Cir. 2004), cert. denied sub nom. *EMC Mortgage Corp. v. Stark*, 125 S. Ct. 1943 (2005).

<sup>2</sup> 514 U.S. 52, 64 (1995).

<sup>3</sup> No. 93 C 2228, 1996 WL 288771, at \*2-3 (N.D. Ill. May 29, 1996).

<sup>4</sup> See *Greening v. Stratton Oakmont*, No. C-95-4288, 1996 WL 61095, at \*3 (N.D. Cal. Feb. 5, 1996).

<sup>5</sup> See *Davis v. Prudential Sec.*, 59 F.3d 1186, 1189-90 (11th Cir. 1995).

<sup>6</sup> *Id.* at 1191-92.

<sup>7</sup> *Supra* n.1.

<sup>8</sup> Appellant’s Petition for Cert. at 1,

*Stark, supra* n. 1.

<sup>9</sup> *Stark, supra* n. 1, 381 F.3d at 800.

<sup>10</sup> *Id.* at 801-02.

<sup>11</sup> 538 U.S. 408 (2003).

<sup>12</sup> *Id.* at 424 (citations omitted).

<sup>13</sup> *Stark, supra* n. 1, 381 F.3d at 802 (citations and emphasis omitted).

<sup>14</sup> *Id.* at 803.